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Structural Policies in Developing Countries

by

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Abstract

This paper discusses the broad orientation of the economic systems adopted in developing countries. While government-led development strategies were widely followed by developing countries since the 1950s and 1960s, a distinct trend towards the adoption of market-oriented systems has developed in the last decade. The paper reviews international trade policies, noting the move away from protectionism, and financial markets policies, where financial repression is also giving way to more liberal systems. The paper also discusses newer ideas supporting "industrial policies" or policies to promote certain export activities, that are partly inspired by the success of several East Asian economies, and observes that their application to other developing countries would not be promising.

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I. Introduction

The key structural policies that shape the economic systems of developing countries have evolved considerably over the last decade. Development strategies in the 1950s and 1960s placed little confidence in markets and entrusted governments with a commanding role in directing the economy. These strategies envisioned an active government involvement in overcoming the development "traps" in which the economies were caught. Thus, the role of the government in the economy would include to increase savings by shifting labor from traditional to modern markets, to create a "big push" for industrialization to overcome low returns due to scales economies and externalities of various forms, and to nurture "infant industries" through protection from import competition (see Krueger (1991)).

The policies adopted in many developing countries in the postwar era, partially inspired in those development strategies, generated inward-oriented, heavily restricted economies with large public enterprise sectors. The record of economic performance under those regimes was largely disappointing. While some (partial) success stories can be found, heavily restricted economies tended to display low growth rates, unstable macroeconomic environments, and widespread inefficiencies. Moreover, an examination of the pattern of government intervention and protection revealed that it actually had little rationality, showing little evidence of generating the alleged positive externalities and learning, for example.

A major shift in the economic systems of developing countries toward market orientation took place in the 1980s. Two events were most influential in this shift. First, the international debt crisis that unfolded in 1982 ended up by persuading many policy-makers that there was something fundamentally wrong with protectionist economic systems. Second, the economic failure of centrally-planned economic systems, that brought about the sharp political changes in Eastern Europe and the Soviet Union starting in 1989, not only initiated the transformation of economic systems in transition economies, but also modified the orientation of systems in many developing countries--notably India--where policymakers had traditionally looked to the centrally-planned economies for inspiration.

The group of "high-performance Asian economies" (HPAEs), as they are termed in a recent World Bank study (World Bank (1993a)), appear to be a special case among developing countries in many respects. Traditionally, the HPAEs were thought to have a fairly free market environment, with the sum total of various forms of government intervention amounting to a relatively minor disruption of market forces. But there is also the view that the interventionist stance represented indeed an important departure from unimpeded markets, at least for some of the HPAEs. But regardless of which assessment is more accurate, it is also true in the case of HPAEs that a significant tendency towards liberalization of foreign trade and domestic markets is under way, although the process has generally been more gradual than in, say, Latin America.

This paper attempts to evaluate the two main structural policies that have shaped the economic systems of developing countries: international trade and financial markets, which are discussed in the next two sections. A final section discusses how current trends in policymaking and economic thought may shape the economic systems of developing countries in the future.

II. International Trade System

Whereas import substitution strategies (IS) were once heralded as the effective path for accelerated development, intellectual consensus has now firmly shifted towards the idea that "openness" and "outward orientation" are necessary conditions for growth and efficiency. Many developing countries that applied massive barriers to international trade in the form of import tariffs and nontariff barriers (NTBs) are removing them and adopting fairly liberal trade regimes. Perhaps the most dramatic examples can be found in Latin America, where much of the literature and practice of IS strategies originated, and where now countries like Chile have one of the most liberal trade regimes in the world. More recently, the opening to international trade has also reached the formerly centrally-planned economies of Eastern Europe, where the old trading arrangements under the Council for Mutual Economic Assistance (CMEA) have been dismantled and many countries have adopted convertibility of the national currency for current account purposes.

1. Protectionist policies in developing countries

The onset of protectionist policies in developing countries can be traced to the 1930s, when Depression-motivated import restrictions in industrial countries, a decline in terms of trade, and external debt service difficulties prompted many developing countries to restrict access to foreign exchange for import purposes and to impose tariffs (Dornbusch (1992)). Even though the scarcity of foreign reserves and the other external problems of developing countries were alleviated after World War II, the restrictive trade policies were generally not dismantled and, in the 1950s and 1960s, inward-oriented IS policies became a centerpiece of prevailing development strategies.

IS policies were predicated on two bases (see Edwards (1993)). The first one was the prediction of a secular decline in the prices of primary commodities (which are largely produced and exported by developing countries) relative to those of manufactures. This is the Prebisch-Singer hypothesis, essentially an empirical conjecture for which evidence is rather mixed. 1/ The second reason (or set of reasons) essentially appeals to the existence of externalities and to the "infant industry" argument, which asserts that new industries need to be afforded temporary protection until they are sufficiently mature to compete internationally. If certain industries generate a positive external effect on the rest of the economy, there is an easy case for government intervention to stimulate their growth. The infant industry argument relies on the assumption that there is a "learning-by-doing" process in certain economic activities, in which the country could develop a comparative advantage over time. However, if there are imperfections in financial and/or labor markets, those infant industries may never get off the ground. Financial markets may be unsure about who would appropriate the benefits from future gains in competitivity. In labor markets, a firm in the infant industry may need to make considerable investments in training workers but may not be able to appropriate the benefits of their higher productivity, as workers may leave the firm after obtaining their training. 2/

1/ For an analysis of trends and cycles in commodity prices, see Reinhart and Wickham (1994).

2/ See Baldwin (1969) for a full exposition (and criticism) of the infant industry argument.

Although their validity is ultimately an empirical question, there are reasons for skepticism regarding both of the above arguments for protectionism. The difficulty with external economies is that it is much easier to presume their existence than to document it (Dornbusch (1992) calls externalities "the last refuge of the scoundrels"). Similarly, the promotion of infant industries would require to identify infant industries, to create an appropriate set of incentives to encourage productivity improvements, and to ensure that protection is *temporary*, which adds up to a high requirement on government performance. Furthermore, from an economic efficiency standpoint, a production subsidy would be preferable to protection in the form of tariffs or trade barriers to support the sector, as it would not impose a welfare loss on consumers.

Trade liberalization initiatives in the 1960s and 1970s were generally quite modest. 1/ But a radical shift in international trade policies in many developing countries became evident in the 1980s, as an increasing disappointment over the economic results of IS policies took hold. In particular, the debt crisis of the early 1980s had a critical impact as it severely affected countries in Latin America and Africa that had for decades pursued IS policies but Asian countries, that had followed outward-oriented trade strategies, were relatively unscathed. This event seems to have persuaded politicians to pursue more market-oriented policies in general, and more liberal trade regimes in particular. 2/

1/ See Papageorgiou, Michaely, and Choksi (1990).
2/ Some skepticism about the value of free trade policies for developing countries certainly still remains. See Rodrik (1992).

2. Outward-orientation and free trade

While moving away from inward-oriented or protectionist policies implies to increase the economy's insertion in world trade, it does not necessarily imply the adoption of a liberal or free trade regime. That is, a country may have a very open economy, in the sense of international trade representing a large fraction of the economy (after correction for factors that make some economies naturally more open than others, such as geographic location) but it may still apply many restrictions on international trade activities. While there must be some correspondence between openness and free trade, it is in principle possible for governments to be highly interventionist with respect to specific sectors without greatly affecting the overall level of international trade that would exist under a free trade regime.

In fact, the case for outward-oriented policies but with an active government involvement in international trade has recently been made in connection with the experience of the high-performing Asian economies (HPAEs). 1/ The case is mainly supported on the existence of sizeable externalities associated with export activities, which would mainly derive from information and reputation considerations. It is argued, for example, that international trade can be an important mechanism for the acquisition of knowledge about production modalities, operational practices, etc. that helps to increase productivity, and that such knowledge would tend to spill over to the rest of the economy, which is clearly valuable from a social point of view. Also, the reputation about the quality of products, and the

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1/ See Stiglitz (1993).

reliability of firms to fulfill commitments gained by some exporters would also tend to spill over to the economy as a whole.

While the above arguments are fairly uncontroversial, the contribution of some export promotion measures to an outward-oriented economy is more questionable. 1/ That is the case of export incentives targeted to certain sectors, or the policy of ensuring a protected domestic market to exporters (World Bank (1993a)) which, in addition to penalizing domestic consumers, work to *discourage* exports from non-favored economic sectors, because of the more appreciated real exchange rate that would eventually obtain.

3. Assessing outward-orientation in developing countries

Although there is general agreement that there has been a very extensive liberalization of foreign trade in developing countries in the 1980s, it is not simple to document that process with hard data. The difficulty arises from two reasons. First, because of the effort involved in putting data together for a number of different countries, most studies measure openness (or trade liberality) at one point in time only. Second, and more importantly, the concept of outward orientation itself does not lend itself to straightforward empirical implementation.

The difficulties with finding a valid empirical measure of outward orientation arise from several sources. One of the reasons is that a good part of the restrictions imposed on international trade are in the form of

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1/ But see Grossman (1989) for a careful analysis of all the conditions that are required for industrial policies favoring certain kinds of goods to be beneficial.

NTBs, which range from mild license requirements to complete prohibitions. Moreover, if openness is measured by outcomes, in order to make meaningful comparisons across countries and over time it is necessary to control for the degree of natural openness, which depends on variables such as transportation costs, GDP, etc. Unfortunately, there is no unique way of correcting for the effect of these other determinants of international trade, and different studies have generated contradictory results, as exemplified in Pritchett (1991).

Table 1 illustrates the drastic trade liberalization undergone by the countries of Latin America in recent years. Even applying the degree of caution recommended by the above considerations, the data displayed in Table 1 are still quite striking. Both tariff levels and the incidence of NTBs have come down considerably in a large number of countries in the region. Moreover, regional trade agreements--involve important trade liberalization measures--are in the process of implementation. The two salient examples are the North American Free Trade Agreement (NAFTA) involving Mexico, and MercoSur (Southern Free Market), which comprises Argentina, Brazil, Paraguay and Uruguay.

Table 1 also shows that countries in Africa, while largely at a different stage of market development, have also accomplished a substantial degree of trade liberalization recently. In most cases, trade restrictions in African countries were motivated by balance of payments needs rather than by an IS development strategy, with foreign exchange rationing and other quantitative controls being the main form of trade restriction. Further, exports were often discouraged by domestic pricing policies that set prices considerably below international levels for agricultural products and other

Table 1. Trade Restrictions in Latin America and Africa

Latin America

Country	Average Tariffs		Coverage of Non-Tariff Barriers	
	1985	1991-92	1985-87	1991-92
Argentina	28.0	15.0	31.9	8.0
Bolivia	20.0	8.0	25.0	0.0
Brazil	80.0	21.1	35.3	10.0
Chile	36.0	11.0	10.1	0.0
Colombia	83.0	6.7	73.2	1.0
Costa Rica	92.0	16.0	0.8	0.0
Ecuador	50.0	18.0	59.3	...
Guatemala	50.0	19.0	7.4	6.0
Mexico	34.0	4.0	12.7	20.0
Paraguay	71.7	16.0	9.9	0.0
Peru	64.0	15.0	53.4	0.0
Uruguay	32.0	12.0	14.1	0.0
Venezuela	30.0	17.0	44.1	5.0

Africa

Country	Controls on Foreign Exchange Allocation		Parallel Market Exchange Rate Premium (Percent)	
	Before Reforms	Late 1992	1985-86	1990-91
Ghana	All	Almost none	142	3
The Gambia	All	Almost none	96	21
Madagascar	All	25 to 50 percent	7	7
Mozambique	All	25 to 50 percent	4,457	63
Nigeria	All	Almost none	235	25
Tanzania	All	Less than 25 percent	253	75
Uganda	All	Almost none	337	24
Zambia	All	Less than 25 percent	36	150
Burundi	All	Almost none	22	21
Kenya	All	Almost none	2	7
Malawi	All	Less than 25 percent	26	29
Rwanda	All	Almost none	39	47
Zimbabwe	All	25 to 50 percent	56	23

Sources: Edwards (1993a), Table 4, and World Bank (1993b).

exports. As noted in a recent World Bank study (World Bank (1993b)), a large number of African countries have largely abandoned the application of import controls for balance of payments reasons and adopted trade regimes that afford more moderate levels of protection and that are much less distortionary. Some African economies have, in fact, moved successfully to fairly liberal trade regimes, notably Mauritius and Ghana, although in many countries the process of liberalization has not advanced continuously and several (mostly partial) reversals were observed.

III. Financial Systems

Consistently with the predominant development strategies, policies towards financial markets in the 1950s and 1960s assigned an important role for the government in the allocation of credit to the sectors considered prioritary for development, and in regulating the level of interest rates offered and charged for different operations. In part, this active government role arose from the insufficient development of financial system, particularly the near absence of equity and venture capital markets. Also, the absence of private insurance markets and the imperfect enforceability of contracts motivated government intervention in the provision of guarantees on deposits and certain loans. Furthermore, in countries with high fiscal deficit and recourse to inflationary financing, financial repression was useful to increase the base of the inflation tax, for example, by forcing banks to hold large low-interest required reserves. Because the economic costs of inflation rise more than proportionately with increases in the rate of inflation, sustaining relatively low inflation with a large tax base could be preferable to a full liberalization of the financial markets, to the extent that the recourse to inflation tax cannot be avoided.

Despite the inadequacy of financial markets in developing countries, it has been recognized that government intervention does involve sizeable distortionary costs. Distortions arise when intervention is not directed at overcoming failures of financial markets but instead at favoring certain sectors. To begin with, the usual second-best argument applies here, namely, that a direct subsidy to the target sector is preferable to a subsidy through credit markets because it avoids creating accessory distortions. One such distortion is that because the cost of capital is being subsidized over that of labor, the use of less labor-intensive technologies is encouraged, often in countries where there is a labor surplus situation. In addition, financial repression produces a crowding out of potentially profitable projects both directly and indirectly because lower interest rates encourage disintermediation and capital flight; it reduces incentives for banks to assess and monitor credit risks properly, and it often results in the accumulation of nonperforming loans by financial intermediaries that generates defensive lending and other distorted lending practices. Moreover, restrictions on the entry of financial institutions and on the scope of allowed activities limits competition and increases the costs of intermediation. Finally, low interest rates discourage savers from holding financial assets, and instead encourage the purchase of real goods and foreign exchange, resulting in an inefficient use of available savings.

1. Experience with financial reforms

A large number of developing countries have taken measures to liberalize their financial systems; as with trade liberalization, financial market reforms have become much more far-reaching in the 1980s, although progress has not always proceeded without interruption. While some of the more extensive financial reforms have taken place in Latin America, such as in Chile, Argentina and, more recently, Mexico, substantial financial reforms have also taken place in Asian economies, notably Indonesia, Malaysia and the Philippines. In Africa, the weak balance sheet position of financial institutions--often the result of extensive directed credit programs--and a still inadequate bank supervision infrastructure have induced reforms to proceed much more gradually. 1/

It has been recognized that financial market liberalization requires a number of institutional and economic conditions to be successful. 2/ On the institutional side, requirements include the development of legal structures, the establishment of accounting regulations and practices, and the introduction of effective banking supervision by the monetary authorities. On the economic side, the main requirement is the necessary adjustment to support low inflation and exchange rate stability. A restructuring of existing financial institutions, and measures to deal with bad loan portfolio problems may also be required. The scope of

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1/ There has also been important steps towards the liberalization and development of capital markets including securities and equity markets, although their scope is still relatively limited in many developing countries. It is to be expected that, because of informational and institutional requirements, equity and security markets would develop only when markets achieve certain degree of maturity.

2/ See, for example, World Bank (1990), Bisat, Johnston and Sundararajan (1992), and Sundararajan and Baliño (1990).

these conditions suggests that the process of financial reform is likely to extend for several years, and that an appropriate sequencing of the different liberalization measures will assume critical importance.

In some cases, however, the absence of markets may require a more detailed government involvement in the process of financial development. For example, financial market institutions were practically inexistent in the transition economies of Eastern Europe, but because of their industrial development, these economies already include large corporations, stock markets, etc. Although laws and regulations can be passed relatively quickly, it will be a long process until mature institutions can really function. The government cannot just set the rules and stand back, but it will have to nurture markets and institutions through active involvement.

The experiences of several countries confirm the relevance of these institutional and economic requirements. A quick financial liberalization with deficient bank supervision and large remaining macroeconomic imbalances resulted in bank failures and runs in Argentina, Chile and the Philippines. In those countries, the banking crises worsened recessionary situations and the external creditworthiness of the countries, and forced the authorities to (temporarily) scale back liberalization measures and, in the case of Chile to renationalize many banks and enterprises that had recently been privatized.

In judging the degree of financial markets liberalization that has taken place in developing countries, one faces the problem that there is no single indicator that can provide a summary assessment. However, the real interest rate is a significant variable to judge the degree of financial repression, as a large negative real interest rate is a sure indicator of interest rate controls and broad credit rationing. The evolution of real interest rates on bank deposits in a sample of 59 developing countries, detailed in Table 2, indicates a trend towards a financial liberalization. 1/ In South America, for example, 5 out of 7 countries were classified as having financially repressed systems in the 1980-84 period, but only 2 out of 9 countries were so classified in the 1985-92 period. 2/ Similarly, 2 out of 3 Central American countries applied financial repression in the 1970-79 period but none out of 4 did in 1985-92. While financial liberalization in African countries has been less widespread, less than half of the African countries in the sample had substantial financial repression in 1985-92.

2. Opening to world financial markets

An important aspect of the sequencing of reforms problem is the timing of opening to international capital markets. In general terms, a full liberalization of capital movements is considered to be the last stage of market liberalization. The reason is that financial markets adjust more rapidly than goods markets, and a premature opening to international financial markets can cause large swings in exchange rates and/or interest rates in a small and relatively volatile economy. Another reason for delaying capital account liberalization is that the domestic financial sector can be considered an "infant industry", requiring some time to

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1/ This data set has been updated from Gelb (1989) and Easterly (1993). I am indebted to Bill Easterly for providing me with these data.

2/ The definition of financial repression is the same as in Easterly (1993) and World Bank (1990), namely, an annual real interest rate lower than negative 5 percent.

Table 2. Real Interest Rates and Financial Repression

	1960-79		1980-84		1985-92	
	Real Interest Rate (*In percent*)	Cases of Financial Repression 1/	Real Interest Rate (*In percent*)	Cases of Financial Repression 1/	Real Interest Rate (*In percent*)	Cases of Financial Repression 1/
South America	-5.88	3 of 4	-9.89	5 of 7	9.20	2 of 9
Central America	-11.12	2 of 3	-2.01	1 of 4	-0.64	--
HPAE's	-1.57	--	1.58	--	6.89	--
Other Asia	-2.39	1 of 6	0.32	1 of 6	3.27	--
Africa	-12.32	7 of 9	-7.99	4 of 10	-10.07	5 of 11

Sources: Gelb (1989) and Easterly (1993), updated by the author.

1/ Countries with average real interest rates lower than negative 5 percent.

develop before being exposed to international competition. While this view might be defensible in some cases, for example in the transition economies of Eastern Europe (see Borensztein and Masson (1993)), most developing countries that have protected their financial institutions from international competition for decades have not shown much evidence of technical progress or learning. Capital controls, moreover, have limited effectiveness in preventing international capital movements, as attested by the estimated massive stocks of capital flight from many developing countries in the context of the debt crisis (see Dooley (1988)).

In recent years, a number of developing countries, particularly in Latin America and Asia, have taken important steps to liberalize their capital accounts. 1/ This liberalization has taken place in the context of a very positive attitude towards investment in developing countries in international financial markets. Under such circumstances, lifting restrictions on capital outflows is certainly easier. What might still be doubtful is whether this process of liberalization can withstand a change in international financial market conditions.

3. Financial reforms and economic growth

Do policies toward financial markets have a significant impact on the economic performance of developing countries? The current growth literature has produced several studies of this link on the basis of cross-country evidence. Since it is very difficult to measure policies towards financial markets in an objective and internationally comparable way, these studies

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1/ See Mathieson and Rojas-Suarez (1993).

rely on indirect indicators of financial repression. These indicators include real interest rates and various measures of the degree of financial "deepening" or development, such as the ratios of different financial aggregates to GDP. 1/ One should note that these two types of indicators may not be consistent. Even under financial repression--indicated by highly negative real interest rates--it is in principle possible for a country to develop its financial markets to some extent. In practice, however, it is likely that all these measures are highly correlated. In fact, irrespective of the indicator being used, studies have found a positive effect of financial liberalization or development on economic growth on the basis of cross-country growth equations that correct for the other major determinants of growth. 2/

The question of causality naturally arises in connection with the above studies, particularly where indicators of financial depth are utilized. Namely, is it financial development that stimulates economic growth or is it the case that agents in higher-income countries tend to hold higher volumes of financial assets? While it may be the case that causality in fact runs both ways, there is also evidence that financial development is associated with higher and more efficient investment, which supports the role of financial market development as promoting economic growth.

1/ It could be argued that real interest rates may serve as a proxy for inflation in some countries. Macroeconomic imbalances, inflation in particular, have been found to impact negatively on growth. See Fischer (1991).

2/ See, for example, Gelb (1989), and De Gregorio and Guidotti (1992).

IV. Conclusions

In the aftermath of the international debt crisis and the political collapse of communism, structural policies in developing countries have quite resolutely moved towards building market-oriented systems and reducing discretionary intervention policies. In some cases, this shift was very abrupt, as in some formerly centrally-planned economies and some countries that were hard hit by the international debt crisis of the 1980s. In other cases, changes have been more gradual and incremental, as in some Asian and African economies. But, allowing for some exceptions in specific countries and some partial reversions and hesitation, the general trend has been very sustained.

Paradoxically, when policymakers are starting to embrace (neoclassical) economic principles as a guide, the economic profession shows signs of moving in the opposite direction. Some of the development economics ideas of the 1950s are being rediscovered. This is the case, for example, of the "big push" theory of Rosenstein-Rodan, which proposed government intervention to increase the scale of the markets to a level considered necessary to generate economic development, and which had been nearly discarded for its neglect of the effects of international trade. 1/

Some of the renewed impetus for active development policies come from a reinterpretation of the experience of the HPAEs. The role governments in those economies, traditionally perceived as fairly neutral, seems to be increasingly considered influential in resource allocation. Although there is a significant literature that finds either that industrial policies acted

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1/ See Krugman (1992) and Murphy, Shleifer and Vishny (1989), who actually cast the argument on a somewhat different basis.

to partially detract the impressive economic performance of the HPAEs or that policies were largely irrelevant for the growth performance, there is also an inevitable tendency to try to imitate the success stories. 1/ And, while the HPAEs have been moving quite resolutely towards a liberalization of policies, it has also been suggested that perhaps the more interventionist stance early on may have been a required first stage in the development process (see Stiglitz (1993)).

However, if a renewed stress in the importance of market failures and the role of governments for economic development is to emerge, it would have to deal with one of the main problems associated with traditional development ideas from the 1950s and 1960s: the often poor record that governments have had in trying to implement rational policies to take advantage of externalities, scale economies, learning etc. or to try to remedy market imperfections. As Krueger (1990) reflected, "*government failure*" appears to have been more serious a problem than market failure in the experience of many developing countries.

The challenge then is to develop policies that can counteract market failures without creating dysfunctional markets. For the broad spectrum of developing countries, successful policies are likely to be those that do not place too high a requirement on government performance. Reorienting spending priorities towards education and infrastructure, for example, is a feasible objective. By contrast, discretionary policies, "picking winners" to subsidize and encourage, are examples of types of policies that are likely to result in the same government failures and inefficiencies of the past in most developing countries.

1/ Some of the most provocative articles are Young (1993) and Easterly, Kremer, Pritchett and Summers (1993). See also Ostry (1993), and Lee (1993).

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